

4. Study the extract and data below and answer the questions that follow.

India's strong rupee

❶ **India with a fixed exchange rate**

Until the 1980s, the Indian government did not make exports a priority. The government aimed for self-sufficiency through **import substitution**, including tariff protection. Foreign trade was subject to strict government controls, which included direct control over exports and imports and capital flows, and a fixed exchange rate. The result, unfortunately for India, was a worsening balance of trade that resulted in record current account deficits. In 1993, India began moving toward a floating exchange rate.

❷ **India now with a floating exchange rate**

The Indian rupee appreciated nearly 10% in the first half of 2006, creating a problem for Indian policy-makers. The main reason for the rupee's appreciation since 2005 has been the increase of money flows into India; a major factor being increased foreign direct investment.

- ❸ The impact of these money flows has been to add to India's economic growth, which has created a large domestic market that offers more opportunities for employment. Despite these positive developments, exporters, who are benefiting from India's growth, are increasingly concerned as their goods are becoming less competitive due to the appreciation.

Key Indian statistics:

	2005	2006
Real GDP growth (%)	8.5	9.2
Inflation (%)	4.2	6.2
Interest rate (short-term rate)	5.23	5.72
Current account balance (% of GDP)	–0.9	–1.6

[Source: adapted from http://www.photius.com/countries/india/economy/inda_economy_trade,
21 July 2007 and various issues of *The Economist*]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) import substitution (*paragraph 1*) [2 marks]
 - (ii) real GDP (*table*). [2 marks]
- (b) Using a tariff diagram, explain why the introduction of a tariff might reduce the quantity of imports demanded in India. [4 marks]
- (c) Using an appropriate diagram, explain how an increase in foreign direct investment can lead to an appreciation of the Indian rupee. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the impact of increased foreign direct investment on the Indian economy. [8 marks]